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A Client Service from Stephen B. Paulin, CIC

Managing Risk to Increase Profit

The CFO as Chief Risk Officer

By Stephen B. Paulin, CIC

Today's CFO faces pressure to cut costs, grow revenue, institute controls, and is even put at personal risk for the company's financial mistakes. The CFO's job is really four jobs in one. The first is that of steward, preserving the assets of the organization by minimizing risk and accurately reporting transactions. The second is operator, conducting finance operations efficiently and effectively. Third is strategist, influencing the company's financial direction. Fourth is the catalyst, instilling a financial mindset for risk management and its execution throughout the business.

CFOs of privately owned middle market companies are being called upon to oversee the business' risk management throughout the operation. At the same time risks facing most businesses are becoming more complex, requiring strong risk expertise. Managing risk places the CFO somewhere he/she may not have been in the past − at the epicenter of risk/reward business decisions.

Individually and collectively, risk affects the financial health of the organization. Risk is also dynamic, as one or more risk can cause a cataclysmic chain of events. CFOs should

recognize that risk is not something that can be managed once a quarter or just on Friday's. While there is value to detailed periodic reviews, risks don't change at intervals. Risks appear and have to be continually addressed and integrated into routine decision-making, strategy-setting and performance management.

For CFOs risk management is not just about financial exposures, such as managing cash flow in a down economy, or changes in the price of raw materials. It includes the risk of failing to comply with laws and regulations or errors on financial statements. Nor is it just about operational and strategic risks, such as quality of the workforce, productivity or the potential failure of a major supplier. It includes many facets of the business and the CFO must have the ability to manage the potential effects of uncertainty throughout the operation.

My experience shows that CFOs are accomplished at managing their company's financial risks, and skilled at making appropriate decisions regarding operational and strategic risks. However, the ability for CFOs to understand and manage Hazard Risks (insurable loss) tend to vary widely, and is often limited.

If you examine the types of risks involved, it becomes obvious why. Financial, operational and strategic risks, referred to as Speculative Risks, are managed around the possibility of three distinct outcomes: chance of loss, no loss, or no gain. This is where CFOs concentrate the majority of their time. Whereas, when dealing with Hazard Risk, (sometimes referred to as Pure Risk), the traditional risk management perspective only has a downside. There is no possibility of gain. Examples of Hazard Risks are a theft, fire or product liability. In comparison to other risks, CFOs consider Hazard Risk as the smallest and less concerning risk they face. The primary reason being Hazard Risk is the most quantifiable, because the premium is paid to transfer the risk from the balance sheet. Other types of risks impact the balance sheet in other less tangible and less predictable ways.

The Experts Know the Truth

A *Los Angeles Times* article, entitled, "Adding to CFO's Responsibilities" and a survey of CFOs by Addis Intellectual Capital support the fact that today's mid-market CFO's have a hard time managing both Speculative and Hazard Risk. Both sources indicate that CFOs have limited time and expertise to identify all the exposures facing their business. CFO's said they believe their insurance broker lacks the ability to uncover/address these exposures, and the overwhelming majority described brokers as being transactional

versus consultative or diagnostic. Both published pieces cited that CFO's don't enjoy the process of procuring insurance. Clearly, CFO's have low expectations for brokers, and are concerned about the value of service.

The fact that CFOs admittedly lack experience in risk management and the inability of many brokers to step in and oversee the client's risk program means the company is most likely not addressing specific exposures to loss. I work with many CFOs to fill the knowledge gap, teaching them how to better manage Hazard Risk through a systemic process based on proven best practices, developed during my 25+ years as an insurance professional.

I want to give clients the insight and guidance needed to strengthen proficiency of managing Hazard Risk. It can be difficult for the CFO to know what capabilities their broker needs to have to be able to work together to achieve the best possible outcomes. This includes tracking and measuring performance.

With today's rate increases and growing threats to business, including: cyber liability, global supply chain interruption, compliance with the Affordable Care Act, and the pressure to reduce costs, CFOs have to think differently about insurable risk and reconsider their insurance buying criteria. This means raising expectations and having higher requirements about the broker's role and the overall value we bring to the table. The CFO should hold the insurance broker accountable for delivering critical programs and monitoring them on a regular basis.

I have witnessed the insurance industry's struggle with the concept of value. Historically, we have defined value as a direct function of price, because we have done a poor job differentiating outside of a commodity based transaction. Insurers and brokers have focused on the price of products, not on the ultimate impact and results the buyer experiences. Subsequently, the price of insurance has become the measure, rather than the performance of the broker and his/her ability to control risk.

Insurance and risk management outcomes must be measured for increased profitability, productivity, competitiveness, human capital expense and the impact on owner's equity. This begins with an understanding of what constitutes the Total Cost of Risk (TCOR).

What is TCOR?

The TCOR (Total Cost of Risk) model quantifies the financial impact of valuing risk management program costs against the improved financial impact to the business. This concept works exceedingly well with Workers' Compensation insurance.

TCOR measures the full impact of Hazard Risk inside a business using a model, which consists of four major areas:

1. Risk Financing Costs: Premium
2. Loss Costs
    a. Direct: Deductibles, self-insured retention or uninsured losses.
    b. Indirect: Secondary costs that amount to from one to two times the direct costs, includes administrating a claims and down time.
3. Administrative Costs: Internal activities and outside resources, such as, TPA, LC, and safety incentives.
4. Insurance Regulatory Taxes & Fees, Letters of Credit

Illustration: The TCOR Model

Once a CFO understands the TCOR to the company and how it relates to the business' risks, it's a turning point in understanding the large impact of Hazard Risk and its affect on the other areas of the operation. Gaining a greater perspective about how insurance can provide a broader solution beyond risk financing opens up enormous possibilities to improve business performance. By reducing the Total Cost of Risk, the CFO can reduce the overall cost burden and make the business more profitable and competitive.

This is accomplished in a larger, broad reaching manner than previously utilized with the traditional insurance (price) mindset. Specifically, by reducing TCOR your organization benefits by mitigating or funding your other areas of risk: Financial, Operational, Strategic, and Human Capital. These are impacted by the Return on Investment from the TCOR model as outlined:

- Financial Risk – Includes currency exchange, asset devaluation, accounts receivable, non-payment of contracts, or banking lines of credit. Reducing TCOR makes your company more profitable.

- Operational Risks – The risk a business experiences regarding its ability to operate efficiently. Such risks include the geographic environment, maintaining or improving equipment, acquisitions and supplier inefficiencies. Reducing TCOR allows you to do more with less.

- Human Capital Risk – Whether in good or bad economic times, a business' most important asset is its people. This is the intellectual capital that keeps everything else going. The risk of loss includes not just the health of the worker, but their ability to contribute. Such things as lay-offs or poor morale contribute to this risk. Improving employee wellness and reducing work related injuries increases workforce productivity and contributes to the organization's efficiency.

- Strategic Risk – relates to competitiveness. These risks include loss of key customers, improper product positioning, regulatory issues or customer pricing pressure. Reducing TCOR makes your company more competitive by producing a lower relative marginal cost.

Reducing these controllable costs can amount to savings of between $250,000 - $500,000 or more (annually) for mid-market companies. Those savings can be used to increase EBITDA, capturing previously unrealized profit. Aside from increasing value of the business, it's certainly a gratifying position for the CFO and owner(s) to choose where to direct the savings created by reducing TCOR.

Today's CFO needs an insurance broker with the desire to understand the inner workings of his/her business. The CFO is searching for a new brand of agent: consultative, diagnostic, results-oriented and focused on managing and mitigating risks rather than just selling insurance. The broker must become the CFOs trusted business advisor.

This type of broker has the experience and ability to deliver results through a defined and proven process. The broker must either invest in or have access to critical resource

capabilities, and apply them effectively to reduce important loss and administrative costs in all the aforementioned areas.

There are Four Quadrants of resources. Each quadrant attaches itself inside a business' operation to help further reduce TCOR.

Claims Management and risk control have a direct impact on direct and indirect costs. Claims Management reduces the severity of a specific claim, and Loss Control primarily reduces frequency. While the first two require action, Industry Specific and Specialty Resources require that the broker understand how he can change the client's outcomes with proprietary information and expertise. Let's take a closer look at each:

- Claims Management: An advocate with the ability to impact the outcome of a claim through case reviews, adjusting techniques and closure. Remember there is a multiple impact on indirect losses for every dollar saved. By addressing the reserves, a skilled claims manager can reduce claims through a number of prescribed and innovative pre and post-term tactics. These range from utilizing Nurse Case Managers, subrogation, return-to-work practices, vetting medical providers, litigation management along with in-depth knowledge of protocols and what's appropriate for a given claim.
- Loss Control: If you know anything about loss control, you understand it's an investment, and the outcome is not the activities themselves, but the ROI based

on the results. Loss control must be strategic to support loss mitigation goals. This means getting away from the typical insurer drive by and recommendations that are seen as intrusions into the business' operation and put client, broker and carrier in a contentious position. The insurer should be utilized as a resource, but in a role that is integrated into the problem-solving process at the direction of the broker.

- Industry Specific: A broker with deep industry knowledge is a huge advantage for all parties. Assessing and understanding a business' exposures to loss, within the context of its industry, provides the essential foundation to treating those exposures by structuring an insurance and risk management program that reduces TCOR. This is accomplished through access to and strong relationships with the top insurers in the industry, special programs and negotiated coverages.

- Specialty Resources: There are a myriad of services available to reduce claims and sustain improvement. These include innovative employee pre-screening practices, safety incentives, ergonomic capabilities, actuarial services, HR support, regulatory compliance, Third Party Administrators, captive managers, and environmental assessment capabilities.

A broker with the capabilities, expertise and resources described above can't be the only catalyst and change agent to obtain the desired results without a proven process. The ability to competently execute is an absolute must. The Risk Management Process, which has evolved over centuries is that proven process to effectively reduce TCOR. It is the systematic application of policies, procedures and practices to manage risk and reduce uncertainty, so an organization can accomplish its goals and remain profitable. It is the perfect system for TCOR to operate and achieve maximum results. Yet, most brokers do not embrace and utilize the elements in a coordinated fashion and fullest degree.

Four-step Process to Success

Your path to success is as individual as your insurance needs. Recognizing this important differentiator is crucial, because a company's values, culture and risk tolerance are all unique factors that influence how an operation is run and the results it achieves. The following four-step process provides the necessary information to create a tailored insurance and risk management program that yields positive results:

1. **Analyze:** Discovery and identification of exposures

An extensive assessment is conducted to learn about the organization, discover loss patterns and determine how it compares to best management practices in the industry.

2. **Design:** Plan creation and strategy development

Using analytics, benchmarking and other highly effective methods, a profile is created of the organization's performance to structure a recommended insurance and risk management solution, which supports the company's goals, while minimizing and controlling costs for greater profit.

3. **Engage:** Implementation of agreed upon insurance and risk management programs

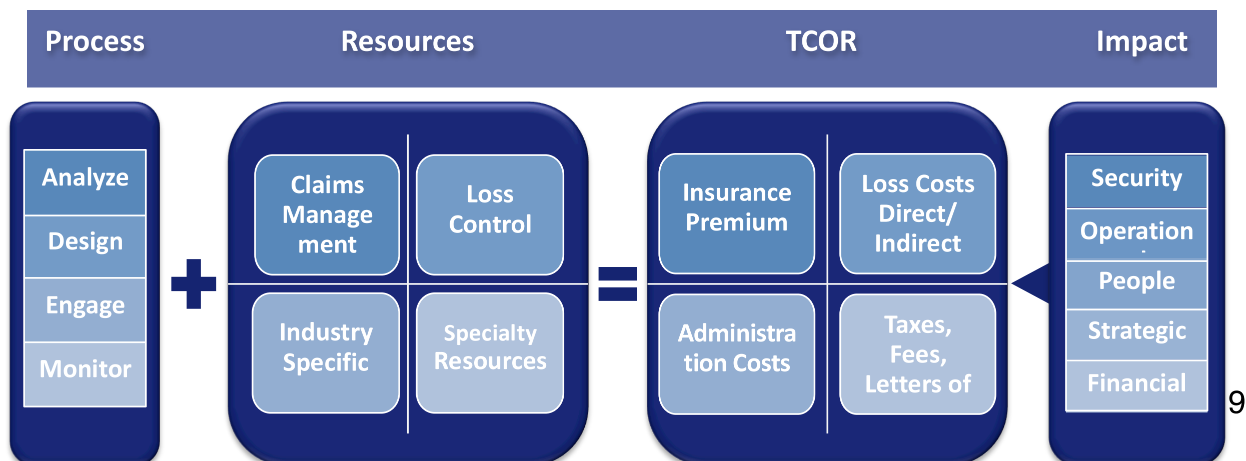
Exposures are addressed by placing coverage and employing tactical, technical and strategic risk management methods, resources and capabilities.

4. **Measure:** Strategic review, monitoring and evaluation

Communicate concise metrics to track, measure and quantify relevant patterns in loss data for quicker, more precise and informed decisions to improve business performance.

The emphasis on price causes many brokers to begin the process at Step 3: Engagement. This gives minimal attention to the first two results in a price based transaction that most assuredly is not appropriately structured to respond to the organization's exposures. How can a broker add value and understand his client's wants, needs, issues, concerns, risk tolerance and business strategy without undertaking a thorough review and analysis? The process is the solution.

The infographic below illustrates how these various elements interact to reduce TCOR and improve business performance.



With an eye toward conducting efficient, effective and profitable operations, CFOs employ numerous processes to manage the many aspects of organizational risk. Attacking business risk in a similar fashion is no exception. Managing business risk with the same level of urgency as other risk will pay long-term dividends by creating a safer workplace, increasing operational efficiencies and productivity, reducing costs, improving competitiveness resulting in higher profit.

The days of just being sold insurance are over. If you're haggling over the price of coverage, without regard to the broker's ability, experience and expertise to advise you in the profitable results of a well-executed risk management program you are not fulfilling your commitment to your company.

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